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— SHAPING CANADA'S FUTURE —

Submission to the
Minister of Finance,
Government of Canada

on: "A NEW DIRECTION FOR CANADA"



March, 1985



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Executive Summary

CANADA'S PROBLEMS AND OUTLOOK

Since the mid-1970's Canada has been experiencing declining rates of economic growth and productivity, combined with high rates of inflation, unemployment and growth in government spending. Our economic performance has been disappointing, both absolutely and relative to our international competitors. Indeed, Canada's share of world export markets fell from 5.1 per cent in 1970 to 3.2 per cent in 1980. Canada faces intensifying competition on the international trading scene from an increasing number of players, all vying for position in an environment characterized by slow growth, growing protectionism and accelerating technological change. Our ability to adapt to this changing world order is made more difficult by the rigidities resulting from excessive regulation and by the constraints associated with persistently high government deficits.

GUIDELINES FOR POLICY

Before rushing to implement specific policy remedies, it is essential to establish first a unifying strategic direction that will act as a co-ordinating and guiding force for the development of a comprehensive package of economic and social policies. The ultimate objective of these policies should be the maximization of the economic well-being of Canadians by reliance on private initiative working through the marketplace, with the minimum government intervention necessary to ensure competitive market conditions, the provision of legitimate public goods and the realization of equity objectives. General guidelines can be developed which are consistent with the attainment of this overall economic policy objective, and which will act as a framework for more specific policy initiatives: in particular, stabilization policy should have a narrower, less activist role, relying primarily on the automatic stabilizers, and the use of discretionary monetary and fiscal policy as elements of stabilization policy should be limited. Monetary policy should be used primarily to maintain the value of the currency, both internally and externally, and the near-term focus of fiscal policy should be the gradual reduction of the structural part of the federal deficit. Also within this economic policy context, the government's role in industrial and competition policies should be to facilitate necessary structural adjustments, allowing resource allocation decisions to be made in a competitive marketplace. These policies must be co-ordinated so that the approach to trade, taxation, competition, labour, R & D, industrial and stabilization policies are consistent and complementary.

This is particularly true with regard to energy policy, which has the potential to contribute significantly to long-term economic growth but which has been inhibited from doing so by government policies which have been mechanistic, inflexible, inefficient and wasteful.

In light of the economic and demographic problems facing Canada, social policies must also be reviewed. Both the costs and benefits of existing programs and their delivery systems must be reconsidered along with effective and efficient alternatives.

AGENDA FOR ACTION

- The structural component of the federal deficit must be eliminated, by reducing the overall deficit by approximately \$ 15 billion over a five-year period. To this end, growth in government expenditures should be fixed at 2.5 per cent per year, on average, less than the growth in GNP, while at the same time, growth in federal revenues should be increased to an average annual rate 1% in excess of growth in GNP. Over the longer term, a major review of the tax system is badly needed, based upon the principles of fairness, efficiency and simplicity.
- Regulatory intervention should be reduced so that markets are able to operate in an unrestricted manner insofar as possible. To this end, both new and existing regulations should be routinely subjected to cost/benefit analyses to determine their necessity. Where intervention has been directed toward market stability or protection of specific interests, as in the transportation, telecommunications, agriculture and energy sectors, regulatory restraint should be replaced immediately by reliance on competitive market forces.
- Canada – U.S. trade relations should be improved through greater use of bilateral arrangements, within the framework provided by GATT. The negotiation of a comprehensive trade agreement with the U.S. would involve ongoing negotiations on all impediments to trade, including the full range of non-tariff barriers, and would be within the parameters of bilateral agreements sanctioned by GATT. At the same time, Canada should continue to participate actively through GATT to negotiate continued gradual multilateral reductions in both tariff and non-tariff barriers.

- Co-operation and consultation among business, labour and government should be encouraged in a number of ways, including: formal mechanisms, such as the Canadian Labour Market and Productivity Centre, which provides ongoing advice on longer-term problems; informal groups, which meet on an ad hoc basis to recommend specific action on urgent issues; clear avenues of access to individual Ministers for organized interest groups; and, more extensive use of parliamentary committees to air issues of public concern.

ENERGY AND GROWTH

Comparative analysis of the oil and gas and non-energy sectors shows that the oil and gas industry is advantageously positioned to make a significant contribution to renewed economic vitality in Canada, if major changes are made to domestic energy policy. New initiatives must be geared to allowing market forces to operate, providing a predictable regulatory environment, and eliminating the discriminatory and retroactive features of current policies. The following specific policy measures are recommended:

- **Domestic oil prices** should be determined by a market-based system open to the influence of world oil markets. This implies opening the Canadian market to imports/exports of crude oil and products.
- **Domestic and export natural gas prices** should be determined by a market-based system, phased in over two to three years.
- **Revenue-sharing** arrangements should better reflect the high risk and capital intensive nature of energy investments by:
 - establishing a single conventional oil royalty at NORP rates.
 - phasing out the PGRT over the next three years.
 - eliminating PIP grants in favour of transferable, tax-based incentives such as depletion.
 - relying more heavily on flexible measures such as the Progressive Incremental Royalty to ensure government's share of revenue in the Canada Lands increases directly with the amount of economic rent that is available.

- **Canadianization** should be realized through positive inducements to individual Canadians to participate in the ownership of oil and gas companies.
- **Security of Supply** should be encouraged through incentives for exploration and development in frontier and non-conventional areas.
- **Back-in** provisions in Canada Lands should be eliminated.
- **Energy conservation** should be encouraged by price factors as determined in the marketplace.
- **Federal-provincial policy co-ordination** should be used on an ongoing basis to anticipate and resolve problems.

The measures outlined here are designed to identify and address those short-term problem areas which have been impediments to Canada's economic growth and prosperity and which are amenable to specific resolution by Canadian policy-makers. These policy remedies are offered within a policy framework which recognizes the paramount role of individual initiative and which is concerned to reduce regulatory intervention and other restrictions to the efficient operation of competitive market forces. With this overall direction as a guideline and with policy efforts concentrating on near-term problem resolution, Canada can begin to use its natural and human resources more effectively to realize its full potential.

Canada's Problems

INTRODUCTION

The establishment of the Royal Commission on the Economic Union and Development Prospects for Canada and the call for responses to the discussion paper 'A New Direction for Canada: An Agenda for Economic Renewal' (hereafter referred to as "**New Direction**") are symptomatic not only of a renewed understanding of the need for consultation on economic policy, but also of a general concern that there is something wrong with the Canadian economy.

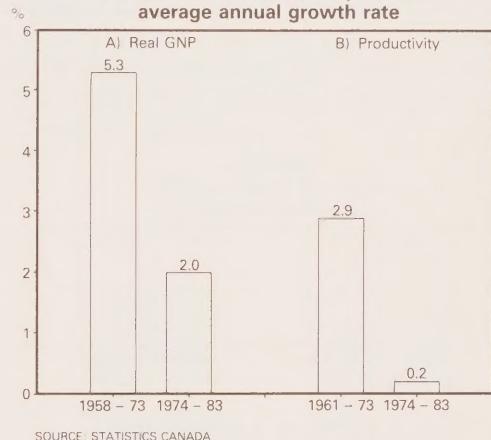
More important than documenting and quantifying every conceivable performance measure for the economy is the ability to identify the major problem areas and focus attention on the search for solutions to these problems. This implies distinguishing orders of importance among concerns and, just as important, starting with areas where there is a high level of confidence that a notable degree of success can be realized in a relatively short time period. It also implies a change of attitude from the predominant reliance on governments for problem solving that has evolved over the past twenty years, to a greater dependence on individual initiative. If governments can direct their attention towards the major difficulties, that is establishing the right framework policies, the smaller problems will be resolved through individual efforts.

In this response to **New Direction**, Gulf Canada Ltd. outlines its views on coming to terms with the predominant economic problems facing Canada. There is no attempt to deal with all the issues raised in the discussion document. On the contrary, the essential recommendation made here is to begin by establishing a consensus on a priority ranking of crucial concerns that are amenable to resolution by policy-makers in Canada. The submission begins with a brief review of the symptoms of the Canadian economic malaise, examines guidelines to policies in key areas, and then addresses more specific near-term policy priorities.

ECONOMIC GROWTH

During the period 1958 to 1973 (the years are chosen for cyclical comparability), Canada experienced average annual real GNP growth of 5.3%. On a per capita basis, the growth rate was an impressive 2.8%, representing a substantial improvement in individual living standards. During the period 1974 to 1983, however, annual GNP growth averaged only 2%. Consumer spending and exports grew at half the rate recorded in the period 1958 to 1973, while growth in investment spending on plant and equipment was at about two-thirds its previous level. Also, per capita real income decreased to a significantly lower 3/4 of 1% per annum since 1974. While the oil price increases of this period can explain slower economic growth in other industrial countries, Canada (due to its substantial domestic oil and gas production) should not have been as vulnerable to this disturbance.

FIGURE 1
Real GNP and Productivity Growth
average annual growth rate



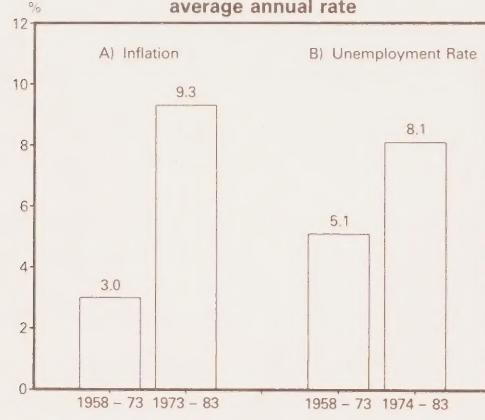
PRODUCTIVITY

Canada's productivity record began to deteriorate significantly by the mid-1970's. Between 1961 and 1973, productivity increased at an average annual rate of 2.9%. This impressive trend was not sustained during the period 1974 to 1983, as productivity slowed significantly. While all industrialized countries experienced generally poor performance during these years, Canada's productivity performance has been one of the worst. Combined with relatively strong nominal wage increases in Canada, this has had the effect of increasing the relative costs of production of Canadian goods, thereby reducing their cost competitiveness in international markets.

INFLATION AND CORPORATE PROFITS

During the 1960's, inflation in Canada rose at average annual rates of 2-4%, similar to the U.S. experience. Canadian inflation, however, outpaced most of its international competitors from 1973 onwards, as the rate of increase grew to significantly higher levels. Over the period 1973 to 1983 inflation averaged 9.3%. At the same time, unit labour costs increased dramatically in the 1970's, establishing a very high base rate of inflation. Companies not able to recover cost increases in the market saw profit performance deteriorate steadily, culminating in a return on capital in 1982 that was the lowest since the 1930's. In reaction to the acceleration in inflation, monetary policy became very restrictive, contributing towards record nominal and real interest rates.

FIGURE 2
Inflation and Unemployment Rates
average annual rate



SOURCE: STATISTICS CANADA

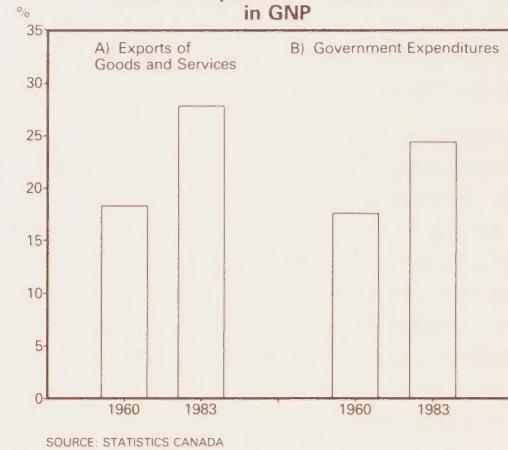
LABOUR MARKETS

The unemployment rate averaged between 4-6% during the 1960's and early 1970's, roughly in line with the U.S. rate. Since the mid-1970's, however, there has been a major secular increase in the unemployment rate, with the Canadian rate exceeding its U.S. counterpart by 4 percentage points in mid-1984. Moreover, measured unemployment rates do not account for the increased numbers of discouraged workers no longer seeking work. Despite the continuing weakness in labour markets, Canada's record of time lost due to work stoppages has been one of the worst among OECD countries since the 1960's.

BALANCE OF PAYMENTS

Canada's dependence on exports is the highest among the top 7 OECD countries. Specifically, Canada's exports as a share of total GNP have increased from 18.3% in 1960 to 27.8% in 1983. According to the OECD measures of relative competitive performance (i.e. relative to the OECD group as a whole), Canada's position was maintained in the early 1970's, improved during the period 1976-1978 as a result of the devaluation of the Canadian dollar, but deteriorated significantly after 1978. Furthermore, Canada's exports as a proportion of total world exports declined from 5.1% in 1970 to 3.2% in 1980. In addition to increasing competition in the trade of manufactured end-products, Canada is experiencing tougher competition in the area of raw materials.

FIGURE 3
Share of Exports and Governments
in GNP



SOURCE: STATISTICS CANADA

GOVERNMENT SECTOR

Total government spending as a percentage of GNP has grown rapidly since 1960, when it accounted for 17.6%, to 24.4% in 1983. Both federal and provincial spending have recorded significant growth in relation to GNP. The provinces in particular are experiencing large increases in expenditures in education, health and other social spending programs. Also, the federal government has recorded large and growing deficits in the second half of the 1970's and in the early 1980's.

Governments have also expanded their intervention in economic affairs through increased regulation and direct participation via Crown corporations.

Canada's Outlook

The emergence of those problems over the past fifteen years reflects the complex interplay between domestic socio-economic trends and an increasingly competitive international economy. Developments already underway suggest that the context for future policymaking is not likely to become simpler. Some of the more significant features of this environment are outlined in the following.

EXTERNAL TRADE

By 1987, import tariffs applicable to the secondary industries of most GATT member countries will have been reduced by approximately 40%. To some extent, however, this trend towards further trade liberalization will be partly countered by protectionist measures in the form of non-tariff barriers. For Canadian industry, both the recent trend to protectionism and the scheduled reduction of tariff rates resulting from the Tokyo Round of GATT present problems and challenges. Slower economic growth, stiffer competition and trade restrictions have contributed to the proliferation of mature markets for many of Canada's resource exports. In our mineral industry there will likely be intensifying competition in the coming years as more countries develop their resources or expand capacity for export markets.

In the manufacturing sector, tariff reductions will have a disproportionate effect on Canadian manufactured products, which have traditionally suffered from problems of high costs and low productivity, rendering them particularly vulnerable to competition from emerging Third World economies. This is of major concern since Canadian productivity levels are much lower than comparative levels in the U.S. (our largest trading partner), Europe and Japan.

TECHNOLOGICAL INNOVATION

Since the mid-1970's we have witnessed a rapid acceleration in the pace of technical advance, which has significantly shifted the positions of competitors in various industries throughout the world. Prospects are for a continuation of this trend towards rapid changes in products and production processes. This advancement will be led by microelectronics and communications technologies but will broaden into many fields. Moreover, an accelerated rate of diffusion of these technical advances to other industries and other countries can be expected as a result of facilitating government policies.

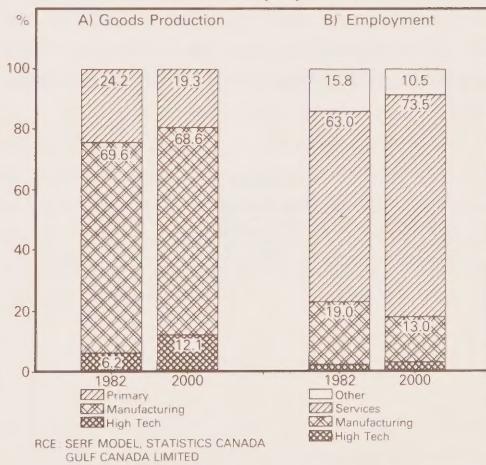
Consequently, the pressure on Canadian industry, which has had a relatively poor record in relation to R & D spending and technical innovation, to keep up to the international pace of technical advance is more likely to intensify rather than slacken.

Changes in technology will affect productivity not only in the manufacturing sector but also in "white collar" areas as electronic communication and computer applications proliferate.

STRUCTURAL CHANGES

Alterations in the composition of domestic demand resulting from demographic trends will supplement shifts in patterns of international trade and contribute to a change in Canada's industrial structure. The poor relative cost positions of many Canadian producers in primary-basic industries will place continuing pressure on them to invest in new labour and material-saving technologies. Furthermore, Canada will have to devote more of its resources to new types of manufactured products in order to maintain its current share of world trade. The impact of these trends on Canada's industrial structure will be significant.

FIGURE 4
Distribution of Production
and Employment



LABOUR MARKETS

Taking into account these anticipated changes in Canada's industrial structure and the expected acceleration in productivity trends, Canada's employment pattern will change significantly. There will be a sharper swing to service sector employment as business services and health care place an increasing claim on output and

employment, while manufacturing employment as a percent of total employment will decline.

At the same time that these influences are changing the distribution of employment, Canada's labour force will likely grow as a result of increasing participation rates for women and young people. With increasing trends in labour productivity, slower growth in end-markets for goods, and rising labour force participation rates, progress in reducing Canada's unemployment rate will be very difficult to realize.

SOCIAL TRENDS

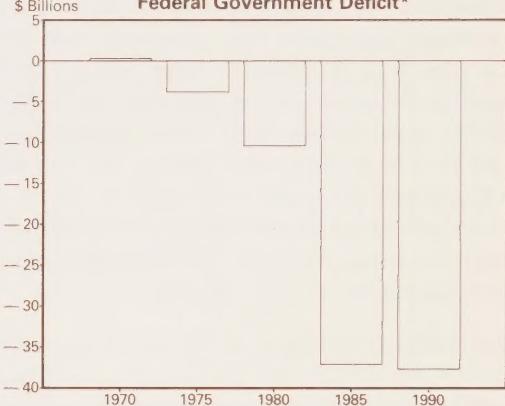
Demographic projections point to an aging Canadian population over the next twenty years and a consequent increase in the dependency ratio. This will imply increased health and pension costs, which will be partially offset by some moderation in the rate of growth of education costs. Recent studies have indicated that the cost of supporting the elderly is 2.5 – 3.0 times the cost of supporting the young. The resulting financial burden on governments will be further augmented by continuing high unemployment rates, which will require substantial income transfers to those adversely affected.

Changes in industrial structure will cause labour market dislocations which will increase the need for retraining programs. This trend combined with technological advancement will alter the nature of education requirements.

GOVERNMENT DEFICITS

Based on no change in current government policies, federal government annual deficits would remain in the range of \$34 billion to \$37 billion between 1985 and 1990. This would imply continued rapid increases in the stock of federal debt outstanding. By 1990, for example, the federal debt outstanding would have doubled again from its current level, reaching 60% of GNP. As a result, interest on the federal debt would have grown from 25% of total government revenues in 1984 to almost 30%. At this point the federal government would be borrowing to pay interest and fiscal policy would have lost virtually all flexibility to deal with cyclical or other objectives.

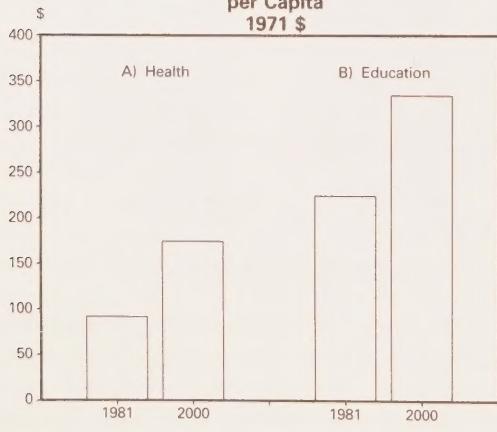
FIGURE 6
Federal Government Deficit*



SOURCE: DEPARTMENT OF FINANCE,
GOVERNMENT OF CANADA

* Budgetary Deficit

FIGURE 5
Health and Education Costs
per Capita
1971 \$



Guidelines for Policy

Before focussing too quickly on specific policies and programs it is essential that a unifying strategic direction be established, that can act as a co-ordinating force for the various elements of a comprehensive economic and social policy package. It does not make sense, for example, to establish economic development, competition, trade and energy policies that are working at cross purposes. This appeared more often than not to be the case during the 1970's.

Economic policies will always involve trade-offs but counter-productive conflicts will be minimized by clarifying objectives and establishing directional guidelines for the main policy components. To begin with, the overall objective of economic policy needs clarification, namely, to maximize the economic well-being of Canadians by relying on private initiative with the minimum intervention of governments that is necessary to ensure that: (i) markets function in a competitive manner; (ii) legitimate public goods are provided as required; and, (iii) equity objectives are realized with minimum disincentives to individual effort. General guidelines for the major elements of economic policy that are consistent with the attainment of this objective are described in the following. More specific identification of policy priorities and recommended actions are described in the next section of this submission.

STABILIZATION POLICY

During the 1960's the federal government experimented with countercyclical demand-management policies with encouraging results. The federal budgetary position varied between small deficits and surpluses and the money supply (M1) grew at an average rate of between 5-6% per year. Economic growth was strong, inflation and interest rates were low (by today's standards) and business cycle swings seemed to be moderating in amplitude.

Then in the early 1970's growth in the money supply accelerated rapidly and, following the oil price increase of 1973-74, federal government deficits began their steady climb to the current level of around \$35 billion. Stabilization policy appears to have been unable to deal initially with stagflation and currently with an intractable unemployment problem. At the present time, both the principal tools of demand management policy seem to be totally constrained. Monetary policy is geared to

protecting the Canadian dollar from further serious depreciation vis-a-vis its U.S. counterpart. Furthermore, fiscal policy is immobilized by an intransigent unemployment problem on one side and a rapidly mounting federal debt level on the other. The lack of flexibility in both areas has provided the impetus to look at income controls as an option.

The active use of monetary policy for stabilization purposes has always been of debatable efficacy. Time lags in implementing policy shifts, an uncertain linkage to expenditures and the inherent constraints of a small economy with a capital market integrated with that of the U.S. impose serious limitations on its effectiveness. Fiscal policy, on the other hand, can be better targeted but is often very difficult to reverse. Programs take on a permanency which lead to structural rigidities.

Against this background a less interventionist and more targeted approach to stabilization policy is recommended. Specifically, monetary policy should play a minimal role as an active element of stabilization policy in favour of a primary emphasis on the maintenance of the value of the country's currency, both internally and externally. This implies foregoing attempts to manipulate expenditures through controlling interest rates and accepting a growth range for the money supply, subject to occasional deviations related to exchange rate objectives.

On the fiscal side, maximum responsiveness to cyclical variations in both directions and in a timely manner is best achieved through the operation of the automatic stabilizers. Discretionary measures should be limited to discrete public investment projects that have a finite life and can be initiated during periods of excess capacity. The immediate focus, however, should be to gradually reduce the structural part of the federal deficit over a period of four to five years.

INDUSTRIAL POLICIES

In an environment where so many fundamental industries appear to require assistance in adjusting to the new state of international competition, limiting government policy to the maintenance of a stable economic climate has been rejected by those seeking more active industrial policies. These policies generally consist of government measures that in some way directly affect the pattern of industrial investment in pursuit of the key goals of economic restructuring and overall improvement of productivity and competitive positioning.

Views on industrial policy in Canada, over the years, have covered a broad variety of approaches. All approaches recognize, however, the major problems facing Canada:

- its small domestic market size constrains the secondary manufacturing sector;
- Canada is largely alone in a competitive world of giant trading blocks;
- the competitiveness of the manufacturing sector has deteriorated compared to our major trading partners; and
- there are significant divergences in regional performances and interests.

In summary, Canada lacks the advantages of both large domestic markets and access to other markets on a preferred basis. As well, it suffers from a failure to organize its own economic affairs on a coherent, consistent basis to confront vigorous competition from abroad.

Alternative approaches to industrial policy in Canada range from the Economic Council's support of "free trade" at one extreme to the Science Council's support of "technological sovereignty" at the other extreme.

The "free trade" approach focuses on the reduction or elimination of tariffs and non-tariff barriers, which would provide access to a larger market, stimulating private measures to increase competitiveness, especially cost competitiveness. The "technological sovereignty" approach is concerned about the disruption that could ensue from "free trade" and argues that technological progress is essential to socio-economic development. While these two approaches agree on ultimate objectives, they differ significantly on the priorities for policy action. The "free trade" approach confines the role of government to framework policies while "technological sovereignty" insists upon a significant degree of sectoral government intervention. Between these extremes are many approaches to industrial policy, which range from phasing out sunset industries to encouraging the application of new technologies in core industries to improve their competitive performance.

The new environment of the 1980's will require rapid adjustment to major changes in world economic developments. For this reason, industrial policies must be designed to facilitate change and adjustment and support the new (and ever-changing) industrial structure. The market, not government, should determine investment

initiatives. For example, government policy should be horizontal, giving incentives to certain general categories of investment such as R & D, high risk projects, skill development, and the application and diffusion of new technology. It must also accommodate structural shifts, easing and accelerating the adjustment process by improving the responsiveness of labour and capital to change.

Based on Canada's historical reliance on international trade and its requirements for major infrastructure developments, industrial policies are not new, but instead are a part of our economic history. The need for an industrial policy in Canada is not so much a call for a greater degree of government involvement in the affairs of specific industries but rather for a co-ordinated approach to economic policy involving trade, taxation, competition, labour, research and development, industrial and stabilization policies. Greater attention must be given to the co-ordination of the various aspects of economic strategies, ensuring that input is provided by all of the principal economic participants. The role of government should be to facilitate the adjustments, with resource-allocation decisions being made at a decentralized level in the market place.

The co-ordination of the diverse dimensions of economic policy, including quicker adaptation to external developments, will require input and co-operation from the principal partners in the economy. Attempts to develop consultative mechanisms have not been particularly successful in the past. Nevertheless, effective avenues for communicating interests and policy decisions will be essential to improving economic performance.

ENERGY POLICY

The energy industry has been one of Canada's leading resource industries with strong long-term potential and a competitive cost structure. As a result, energy policy has attempted to balance economic efficiency with control because of its pervasive influence on the economy.

The first OPEC shock in 1973 reinforced the need to strengthen the east/west nature of Canada's economy. Ottawa responded by implementing oil export controls, extending the IPL pipeline to Montreal, freezing domestic oil prices and subsidizing consumers of energy. These policies were seen by the producing provinces as interference in traditional areas of provincial jurisdiction.

Federal-provincial disputes heightened and relations between the Federal Government and Alberta deteriorated.

With the second hike in OPEC prices in 1979, these trends in energy policies were further emphasized with the unveiling of the National Energy Program. The philosophy behind the NEP was based upon the belief that the Canadian energy market was not sensitive to market forces such as prices and that the Canadian energy market could be insulated from world forces and controlled by government intervention. In addition the NEP was based upon a number of assumptions that have already proven to be erroneous, namely continuous increases in world energy prices, vast readily available reserves in the Canada Lands, and rent distribution as the key energy issue.

The last few years have placed enormous strains on the NEP resulting in numerous adjustments, including revisions to the PGRT, abandonment of IORT, continual reviews of the NGGLT, redefinitions of the vintage accounting for oil (COOP, SOOP, NORP), and many new fiscal agreements to support the start-up of new projects (Cold Lake, Norman Wells, etc.). The major objections to the NEP are threefold:

- First, the approach was mechanistic and not adaptable to an environment experiencing significant change.
- Second, very little consideration was given to optimum resource extraction policies.
- Finally, the methods chosen to fulfill the goals of the policy are inefficient and wasteful.

As a general guideline, Canadian policymakers must assign a greater emphasis to the goals of economic growth and development in setting energy policies, with appropriate acknowledgment of the importance of international market signals.

COMPETITION POLICY

As indicated earlier, it is essential that Canada establish as one of its primary development goals the capacity to adapt to standards of productive efficiency established in world markets. Domestic industry must be encouraged to undertake large-scale projects that are clearly in the public interest (e.g. energy sector joint ventures) on both a

national and international basis. To achieve these objectives it is essential that domestic competition policy, while fulfilling its role of ensuring highly competitive and therefore efficient markets, not act to impede necessary industrial adjustment, the promotion of efficient, large-scale operations, or legitimate responses to competition in the marketplace.

Accordingly, prior to advancing proposals for the reform of Canadian Combines legislation, government must first clearly define its industrial development policies and then identify features of a competition policy that are consistent and reinforcing. Based on the exigencies of international competition and the need for flexibility, rigid categorization processes based on size or market share as a fundamental criterion for the regulation of mergers and monopolies should be eschewed in favour of more adaptable approaches. Fundamental to an evaluation of whether or not intervention is necessary is the potential contribution to economic efficiency and growth.

In the case of mergers, for example, consideration should be given to review only whenever the relevant transaction is national or international in scope, and the transaction, if completed, would result in significantly less competition (including foreign competition) remaining after completion. Similarly, a scale criterion for the identification of monopoly conditions should be rejected in favour of review of true monopolies, where such monopoly position is intentionally used in such a manner that competition is significantly and detrimentally affected, and where the public derives no benefit from the business activity involved.

Particular care must be given to avoid including in definitions of anti-competitive behaviour or "inferred" conspiracy, actions which are normal and legitimate competitive behaviour.

Competition policy must be viewed as part of a policy mosaic that fits the needs of the Canadian economy, rather than a grafting of measures introduced in other political and economic contexts.

SOCIAL POLICY

Over the past twenty years we have seen transfer payments grow steadily as social programs proliferated during a period of strong overall economic expansion. The growing structural deficit discussed earlier suggests that

we can no longer afford continued growth in these programs without a significant increase in taxation. It is appropriate, therefore, to reconsider the benefits and costs of these measures and whether or not we have gone beyond the point of providing a social safety net to the extent of redirecting resources to governments that could be better utilized by Canadians making their own economic decisions. Given a re-emphasis on individual initiative, it is important to determine whether current levels of taxation and expenditure are not acting as impediments to the levels of effort that should be encouraged.

But reducing the federal deficit through constraints on social programs cannot be relegated to an arithmetic exercise. Decisions on elderly benefits, for example, cannot be taken outside the context of a comprehensive approach to policies dealing with pensions in general. In this regard consideration must be given not only to the ability of current elderly benefits to provide a minimum level of income but also to the funding requirements of an aging population, the ability of employer-sponsored schemes to meet the needs of an economy in which workers may have to change jobs on several occasions, and the extent to which private saving should be encouraged.

Similarly, the dramatic growth in federal transfers to the provinces would suggest the potential for constraints or cuts that would improve the federal deficit. However, any revisions in these transfers must carefully consider the fiscal balance between levels of government, including the shifting responsibility for the provision of social services.

It is evident that, given their size and growth, federal transfer payments will have to be constrained if fiscal responsibility is to be re-established. But this will have to be done by means of a careful cost-benefit analysis of underlying programs, involving the provincial as well as the federal governments. The imposition of additional constraints on the options available to governments in dealing with these problems should be avoided. In particular, the federal government's recent decision not to use any savings from efficiencies realized in changes to elderly and child benefits programs to reduce the federal deficit is an unfortunate one.

Agenda for Action

The policy guidelines just outlined provide a co-ordinated set of directives for improving Canada's economic performance in the environment that is expected during the 1980's and 1990's. But, as indicated earlier, it is not practical to expect to resolve all major problem areas at once. There is an immediate need to establish priorities for action in the short-term. These should be few in number and should be areas where there is a high probability that policy initiatives will be successful.

In the following, five policy priorities have been identified on the basis of their contribution to removing obstacles to growth, building on growth opportunities, and achieving a national consensus. In each area, recommendations are made for policy actions.

FISCAL CONTROL

The federal budget deficit has risen steadily from about 2.3 percent of GNP in 1975 to approximately 8.2 percent in 1984. As a result of these growing and continuous deficits, net federal debt outstanding has increased from 15.5% of GNP in 1975 to close to 45% at the present time. Higher debt levels combined with rising interest rates have increased net interest costs from 4.4% of total federal revenues in 1975 to 25 percent in 1984. Furthermore, without major changes in fiscal policy this trend towards rapidly rising debt levels will continue into the foreseeable future. Most projections, including those in **New Direction**, anticipate a debt/GNP ratio in 1990 of about 60%, with interest costs increasing towards 30% of total revenues.

Some observers have argued that continuous deficits of this magnitude should not be a matter of concern given the current level of excess capacity in the economy and hence the need for stimulative fiscal policy. However, most estimates show that even after allowance for the cyclical position of the economy, there still remains a structural deficit that is between \$15 to \$20 billion. Estimates in **New Direction** indicate that with strong economic growth and a falling unemployment rate, which should reduce the cyclical deficit, there nevertheless will remain an overall deficit of \$37 billion in 1990.

The arguments against growing deficits are persuasive. Higher deficits require greater government borrowing, which results in higher interest rates and/or the crowding out of private borrowers from Canadian capital markets;

greater federal cash needs place expansionary pressure on monetary policy and contribute to inflation; the burden of paying for current expenditures is placed on future generations; a growing share of the economy's resources are commandeered by governments reducing overall efficiency; the flexibility of fiscal policy as a stabilization measure is substantially reduced; and, deficits that arise from current rather than capital expenditures reduce the economy's capital stock below its potential, thereby constraining long-term growth.

For these reasons and because of the widespread concern that government expenditures have simply grown out of control, a consensus has emerged calling for the control of, and a gradual reduction in, the size of the federal deficit. The real issue at the present time is how this can be accomplished in a responsible manner.

Federal Expenditures

Overall Federal government expenditures have grown rapidly since 1960, increasing at an average annual rate of over 12%. As a result, federal spending as a ratio of GNP has climbed from 17.6% in 1960 to almost 25% in 1984. Shifts among the components of government spending reflect changes in priorities over time. For example, expenditures on defence and industrial development have fallen as a proportion of total spending; expenditures on internal services have remained constant; while expenditures on social programs, transfers to provinces and interest costs have risen sharply.

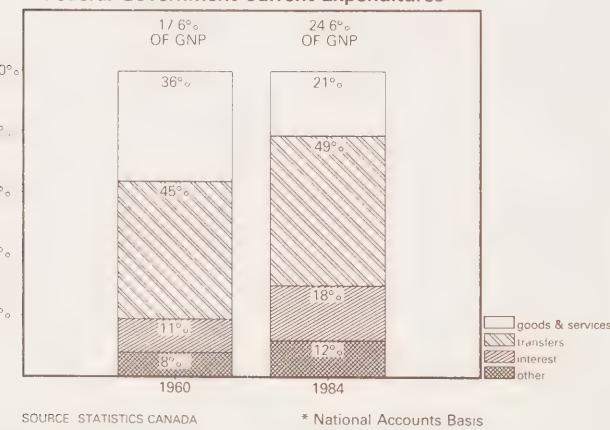
Based on the relative magnitudes of the expenditure categories, it is clear that any major reduction on the spending side would have to affect transfers to people, business or the provinces in a substantial way. This would necessarily involve difficult trade-offs in sensitive program areas. For example, proposals to cut back elderly benefits through any of the methods mentioned in **New Directions** would have an impact on the overall adequacy of pension arrangements in Canada. Changes to Unemployment Insurance could affect not only the economic well-being of recipients but also the viability of new training and re-training programs. Cuts to industrial development programs will affect economic activity both nationally and regionally.

A strategy to control Federal government spending cannot start at the bottom, focusing on individual programs and their potential contribution to spending cuts. Rather, the first decision must relate to the overall size of government that the public is prepared to finance.

This must be determined at the same time that revenue decisions are made. As will be pointed out in the following section, a significant contributor to the structural deficit has been the failure of tax revenues to keep pace with expenditures because of various tax allowances. Consequently, a partial solution to the deficit problem could be the re-establishment of the effective tax rates prevailing in 1974. This requires a decision on the share of total output to be channelled through government or, in other words, the size of government that people are prepared to pay for.

After having established total government expenditure in relation to GNP, the next set of decisions relate to the composition of expenditures. As indicated above, this is primarily a matter of trade-offs among political objectives. Opportunities to provide input on preferences for particular programs must be provided to ensure the best information is available for decision making, but this input will necessarily reflect special interests. Once the political choices have been made, the final step is to ensure that programs are delivered efficiently. As recent reports to the Auditor General have pointed out, this is not an insignificant matter and in this regard input may again be expected to be essentially unbiased, relating to the criteria for assessing efficiency.

FIGURE 7
Composition of
Federal Government Current Expenditures*



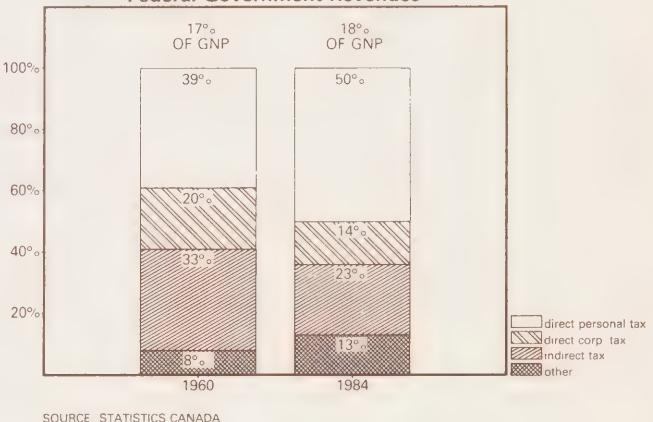
Tax Revenues

Federal government revenues increased from just over 17.6% of GNP in 1960 to over 20% in 1974 before falling again to 18% in 1983. The expansion in the earlier period was largely due to strong growth in personal income, combined with a progressive personal income tax system. This influence was augmented by the tendency of inflation

to increase effective tax rates within this system. The growth in personal taxes was strong enough to offset moderating shares of federal corporate and indirect taxes.

In 1974 the indexation of personal tax exemptions and tax brackets eliminated the built-in escalation of revenues, requiring discretionary tax rate changes to increase revenues. Subsequent income tax exemptions or allowances reduced the responsiveness of tax revenues to income increases. On the personal tax side, MURB's, RHOSP's, and RRSP's, for example, have limited growth in the personal tax base. On the corporate side, measures such as the two-year write-off for investment in manufacturing processing, lower tax rates on small business and so-called tax expenditures in the resource sector have all contributed to the relative decline in corporate taxes as a source of federal revenue.

FIGURE 8
Composition of
Federal Government Revenues



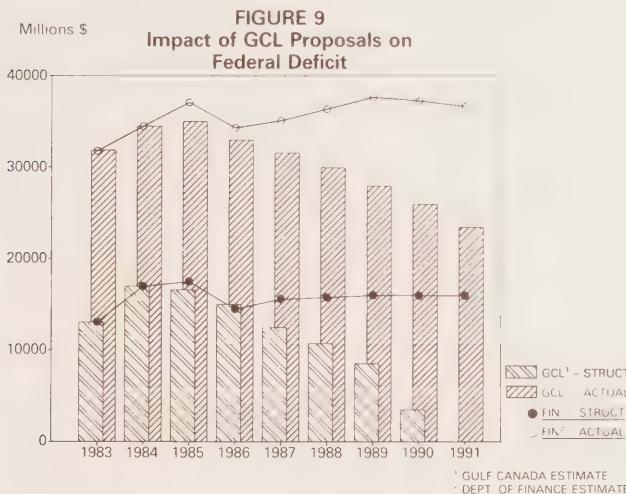
Given the size of the structural deficit and the fact that a part of its origin is in the failure of tax revenues to keep up with GNP growth, consideration must be given to increasing revenues as well as cutting expenditures. While raising revenues could be achieved within the current tax structure, it would result in further patchwork on a tax system that is already overly complicated and replete with special provisions that have altered its equity features substantially.

Recommended Action

To begin, a commitment is required to eliminate the structural deficit over a reasonable period of time. While there remains considerable controversy over the size of this deficit, Gulf Canada would suggest an overall

reduction in the deficit of approximately \$15 billion over a period of five to six years should be set as an objective.

Measures to achieve this goal should affect both the expenditure and the revenue side and in an equitable manner. On the expenditure side an overall objective should be established that keeps growth in government spending, on average, a fixed amount less than growth in GNP – a difference of 2.5% per year is suggested. This would ensure that the structural deficit would gradually decline over time even without a change in tax rates. This aggregate expenditure target would indicate the total resources available for the various categories of expenditure programs. All categories should contribute some part of the growth reduction with the relative weights dependent upon the political trade-offs among social and economic objectives.



On the revenue side it has become clear that a major review of the tax system is in order. The grafting of various special features onto the present system over the years has left it highly complex and with uncertain goals or emphasis. Beginning with the principles of fairness, efficiency and simplicity, this review should examine alternative approaches to raising sufficient revenues to cover the cost of the government that Canadians want, while minimizing the distorting effects of high marginal tax rates on individual effort.

Since this review is likely to take some time, it will be necessary in the interim to introduce measures that increase effective tax rates. The objective here should be to cause total federal revenues to grow at an average annual rate slightly in excess of that for GNP – a 1% differential is recommended. In deciding on the specific

tax changes to be introduced, care must be taken to avoid significant behavioural changes that would work against improving Canada's international competitive status. That is, while reductions in some tax expenditures may be in order, changes that would adversely affect investment spending should be avoided. Tax increases that affect consumption rather than savings and investment should be emphasized as part of the interim improvement of government revenues.

The important point is that the commitment must be made now to eliminate the structural deficit. The specifics regarding growth relationships, program adjustments etc. can be decided on without significant delay, but after further analysis and input.

THE BURDEN OF GOVERNMENT REGULATION

The extensive regulatory intervention that Canadians have come to expect has not always been a characteristic of our economy. In the early years, particularly at the beginning of this century, government's focus was on establishing equitable "rules of the game" and on protecting consumers in the case of natural monopolies. During the Depression years of the 1930's, governments became more interventionist to protect various segments of society affected by extreme economic hardship. In the past twenty years we have witnessed a rapid growth in regulations and regulatory agencies covering a broad range of economic activities and directed not only towards the protection of consumers and the environment but increasingly towards protection of special interest groups.

The cumulative effect of this growing regulatory intrusion has been to redirect the allocation of resources in the economy in a significant way and in the process redistribute revenue through the provision of subsidies in an indirect manner that is normally difficult to quantify. Those adversely affected have typically been too dispersed to act as an effective opposition to regulatory initiatives.

In addition to these resource allocation concerns arising from growing regulation is the fact that the flexibility of markets has been seriously curtailed, restricting their ability to adapt to changes in technology, consumer preferences and foreign competition. In all cases, regulation implies limitations on individual choice and, as the extent of regulation has grown, it has also meant substantial direct costs related to the required administrative apparatus.

This is not to suggest that completely unconstrained markets would automatically result in an optimal allocation of resources in all circumstances. A case for government intervention can be made in regard to:

Natural monopolies – the economies of scale imply only one producer who can exercise monopoly control.

Externalities – not all of the benefits and costs of a given economic activity accrue to the buyers and sellers e.g. air and water pollution.

Insufficient information – buyers have insufficient information to understand the consequences of a transaction that could affect them in a significant way e.g. product labelling.

Social considerations – the market outcome may be unacceptable on equity grounds implying the need for intervention e.g. safety and health regulations.

A further basis for intervention, which has been used extensively in recent years, has been the assurance of orderly markets. This has most often meant the protection of certain participants in these markets through price, volume, entry or exit controls. This is the area that carries the greatest potential for economic inefficiencies and, consequently, requires particularly critical analysis.

Both the House of Commons Special Committee on Regulation and the Economic Council of Canada have called for fundamental changes in the extent and nature of government intervention in the economy. The Economic Council concluded, "Our research suggests that Canada's comprehensive system of direct economic controls has resulted in a substantial waste of economic resources and reduced the degree of dynamism and innovation in several important sectors of the Canadian economy".

Recommended Action

Reform should start with the process for establishing and maintaining regulations. Before implementing new regulations the government should be required to exhibit convincingly that the associated benefits outweigh the costs. Once in place, regulations tend to be very difficult to reverse, even when the initial need for them has long since passed. Existing regulations should also be subjected to routine reviews with the ingoing assumption being that unrestricted markets should be relied upon unless a convincing case can be made otherwise. Both the House Special Committee and the Economic Council recommended parliamentary committees as the appropriate vehicle for these reviews.

Even in the case of natural monopolies, technological changes over time (for example the telecommunications industry) and the emergence of close substitutes or foreign competitors often fundamentally change the original circumstances that gave rise to the need for government intervention. These cases should also be reviewed regularly.

The existence of negative externalities remains a legitimate basis for regulation. But here consideration should be given to improving the administrative apparatus and to innovative approaches that could improve the efficiency of government regulations. One example that has been discussed extensively in this regard is the notion of tradeable emission permits. Techniques such as these tend, in general, to internalize the costs of using common property. Similarly, regulations designed to ensure adequate information to consumers and to provide for social objectives such as health and safety are necessary but should be designed to minimize the ultimate cost paid by consumers.

Where intervention had as its objective, market stability or protection of specific interests, measures should be introduced immediately to relax regulatory restraints and increase reliance on competitive forces. This would include such areas as transportation, telecommunications, agriculture and energy. The oil and gas industry in particular has been regulated in virtually every part of its operations. The resultant market distortions and economic costs have been many, from delays and cost increases related to exploration in frontier areas to the retardation of market adjustments to higher world prices. If the industry is to contribute to its full potential to the Canadian economy a drastically changed attitude towards regulatory intervention is required.

In summary, the extent and nature of government intervention in the economy is now excessive and needs to be reduced to instances that can be justified on a rigorous basis. The objective should be allow the economic advantages of free market operation to be realized whenever possible.

TRADE EXPANSION

As both **New Direction** and the recent discussion paper on trade clearly recognize, Canada is a trading nation and the key to our future prosperity lies in our ability to enhance our export potential. The development and implementation of national strategies designed to

maximize economic revitalization, industrial growth and new job creation must complement and centre on strategies to improve Canada's lagging trade performance. As noted earlier, Canada is the most export-dependent of the top seven OECD countries. At the same time, our share of total world exports declined during the seventies as competition intensified among developed and newly developing nations to capture a larger share of the export markets for both natural resources and manufactured goods in an increasingly protectionist environment. A critical factor in strategies to improve Canada's trade position must, therefore, be ongoing efforts to liberalize the rules and practices of international trade.

In theory, there are a number of alternative policy directions available to Canada in attempting to expand our international trade, ranging from protectionist and isolationist policies at one end of the spectrum to unilateral free trade at the other. The former option is not viable for a country like Canada with a small domestic market, huge geographic territory and limited range of existing manufactured products. It would be impossible for Canada to achieve economies of scale in many manufactured goods, and by closing off our markets to imports, we would be vulnerable to reciprocal action against our exports, principally natural resources.

The latter option involves dropping our tariff barriers without the guarantee of reciprocal action on the part of any of our trading partners. This proposal would, of course, result in an increase in imports and in unfair competition for Canadian producers. In a trading environment that is moving toward the erection of more non-tariff barriers, unilateral action to remove all restrictions is neither practical nor sensible. It eliminates any leverage Canada might have in negotiating with current or new trading partners.

Other more moderate options such as sectoral, reciprocal or functional free trade agreements also have important drawbacks, which will be discussed further below. Principally, the drawbacks include their incompatibility with GATT and the difficulty in determining mutually agreeable areas of priority.

Therefore, in practice, as a small nation in the international marketplace Canada's interests are best served by continuing to participate actively through GATT to negotiate a gradual reduction of both tariff and non-tariff barriers, in step with other member nations. This

strategy allows Canada the flexibility to generally take advantage of new trade developments, while at the same time concentrating our efforts on enhancing specific trade opportunities with existing and emerging partners, particularly in the Pacific Rim and Asia. However, while GATT has proven to be an effective body for developing consensus on trade policy among many disparate countries, it has been less than effective in ensuring that these policies are implemented and in resolving disputes among members. Canada cannot, therefore, rely entirely on GATT as the vehicle for ensuring that its trade interests are protected.

In light of this significant qualification and the fact that the U.S. is by far our most important single trading partner – 73 per cent of total Canadian exports were shipped to the United States in 1983 – Canada should, within the framework provided by GATT, emphasize improved Canada-U.S. trade relations through greater use of bilateral arrangements. Strengthening GATT and enhancing trade with the U.S. are not mutually exclusive strategies, but should be pursued in tandem. Guiding both should be a recognition that market forces must be allowed to prevail over arbitrary decisions in determining the nature of trade flows. Governments should not be in the business of picking winning sectors or industries, but instead should provide an environment where impediments to trade are reduced and, wherever possible, restrictions are the result of competitive business practices.

Recommended Action

In terms of the U.S. specifically, the immediate trade policy question facing Canada is, therefore, how to extend trade relations with the U.S. while minimizing the potential disruptive impacts on Canada and still maintaining our participation in GATT. Canada has indicated a great deal of interest in the idea of negotiating sectoral free trade agreements, as a kind of step-by-step, gradual approach to broadening trade relations. However, as mentioned, the sectoral approach suffers from the handicap that priority sectors will rarely coincide for both countries. Reciprocal agreements are a variation on the sectoral approach which allow both sides to trade off one industry against another. Both the reciprocal and sectoral strategies suffer from the same fundamental problem, namely the need for politicians to decide which sectors or industries will benefit and which will ultimately decline. This is neither politically palatable nor appropriate and

interest in these arrangements appears to be waning in both Canada and the U.S.

The functional approach to negotiations, which concentrates on eliminating specific types of trade restrictions, is useful in that it addresses structural or policy impediments to freer trade without reference to particular industries. However, it is too narrowly based to achieve overall success and requires partners to have a number of equally injurious policies or legislative impediments in order for negotiations to continue.

The U.S. administration favours a broader approach but is willing, for the moment, to let Canada set the pace. At the same time, however, Congress is becoming increasingly protectionistic, motivated largely by last year's \$109 billion merchandise trade deficit. Evidence of this trend is clear in the omnibus trade bill passed by Congress in October, 1984, not so much by the shape the package finally took as by what it could have been. A great number of strongly protectionist amendments were put forward and in the end, while most were defeated, the Bill expanded coverage of U.S. countervail and anti-dumping laws. Another, larger trade deficit anticipated in 1985 will only serve to add fuel to the protectionist flames.

In light of these conflicting and changeable signals from the U.S., Canada should seize the opportunity to begin investigating the option of negotiating a more comprehensive trade agreement with the U.S. This would involve ongoing negotiations on all impediments to trade, including the full range of non-tariff barriers, without being limited to a discussion of specific industries or sectors or particular policy constraints. This option has the advantage of being within the parameters of bilateral agreements sanctioned by GATT and, therefore, would not require approval by member nations. Nor should it provoke retaliatory measures by other trading partners. Any such agreement would have to be a carefully managed one which would encompass safeguards for both countries in terms of pace and scope of negotiations and which would not jeopardize our standing in GATT.

ENERGY & GROWTH

New Direction pointed out that excessive government intervention and regulation have seriously restricted the potential of the oil and gas industry through the uncertainties created on the part of the public and domestic and foreign investors, and also through the creation of counterproductive federal-provincial tensions. Most importantly, excessive intervention has been largely responsible for establishing a level of investment in the oil and gas industry that is well below what is needed if the industry is to make its full contribution to the economy.

The paper identified the petroleum industry as a major "engine of growth" which would contribute significantly to an improvement in the level of economic activity in Canada. The ability of the industry to play this role, despite the relatively small share of output and employment it represents in the total economy, is due to its tendency to reinvest a large share of its cash flow and the potential for large-scale investments over the remainder of this century. This could have a major impact on other sectors of the economy through the industry's demand for capital goods and services. The role of the oil and gas industry as an engine of growth has been investigated by several studies.

Review of Previous Studies

Comparison of the results of this work is made difficult by the fact that the authors investigated somewhat different problems and in the process made different assumptions. The Canadian Petroleum Association (CPA), the Economic Council of Canada (ECC) and the Imperial Oil Ltd. (IOL) studies all looked at changes in federal government policy that would reduce the tax take and increase revenues received by industry. This would result in increased capital expenditures, with the level dependent upon the size of the incremental cash flows and the reinvestment ratio. Incremental investment levels range from less than \$7 billion for the ECC to \$234 billion for IOL. Obviously, the economic impacts vary widely. A similar approach was taken by the Canada West Foundation, although it did not relate incremental investment to any specific policy changes. Rather, it was concerned with measuring the potential impact of energy sector opportunities, however initiated.

A study by the Ontario Government differed from the others in that it was primarily concerned with measuring the effects of an oil price increase on macroeconomic performance measures. It assumed an increase of \$4 per

Energy and Growth Review of Previous Studies

	STIMULUS	GNP*	EMPLOYMENT*
CANADIAN PETROLEUM ASSOCIATION	<ul style="list-style-type: none"> Altered fiscal arrangements to reduce government take; decontrol of oil prices Industry increases investment by \$70 billion 	<ul style="list-style-type: none"> Almost 3% higher by 1992 Western Canada the major beneficiary 	<ul style="list-style-type: none"> Increase by an average of 200,000 jobs each year Unemployment rate is reduced by 1½% by 1992
CANADA WEST FOUNDATION	<ul style="list-style-type: none"> Increased industry investment spending by \$79 billion – no related production increases Altered fiscal arrangements to improve investment climate; decontrol of oil prices Industry cash flow increased by \$7 billion 	<ul style="list-style-type: none"> Almost 1½% higher after four years Major impact in Ontario and Quebec 	<ul style="list-style-type: none"> Peaks at 62,000 additional jobs before declining to zero
ECONOMIC COUNCIL OF CANADA		<ul style="list-style-type: none"> About ½% higher on average during 1985 - 1995 	<ul style="list-style-type: none"> Employment increases but amount not specified
IMPERIAL OIL	<ul style="list-style-type: none"> Altered fiscal arrangements to reduce tax take; decontrol of oil prices Industry increases investment by \$239 billion 	<ul style="list-style-type: none"> Almost 4% higher by 2000 	<ul style="list-style-type: none"> Employment is 5% higher by 2000 An additional 300,000 jobs per year during 1984 - 2000
ONTARIO	<ul style="list-style-type: none"> Assumed oil price decontrol increases the average crude oil price by \$4-barrel Governments take one half of incremental revenues; industry investment increases by \$1 billion annually 	<ul style="list-style-type: none"> Approximately 1¼% lower over the period 1985 - 1990 Ontario accounts for 50% of loss in GNP 	<ul style="list-style-type: none"> Net job loss approaches 67,000 in 1986

*All estimates are measured relative to their specific base case.

barrel on average in Canadian crude oil prices, which it attributed to oil price decontrol. This, incidentally, is about twice the price impact incorporated in the decontrol assumptions of the other studies. The analysis estimated the incremental revenues resulting from the price increase and assumed that over half of this would go to governments. Of the remainder that went to industry, 80% would be reinvested.

The results of these studies are very difficult to compare because of the differing assumptions underlying each of them. In general, all but the Ontario study showed that compared to the base case, the policy simulations resulted in higher levels of economic activity, higher employment and lower unemployment rates, an improved balance of trade position and for most cases an improved federal government budget balance. The impacts on employment, for example, vary from a minor improvement in the case of the ECC study to an average increment of approximately 300,000 jobs a year in the case of IOL's analysis. Because of the various methodologies employed, it is not possible to normalize the results in all cases through the use of measures such as the multiplier, that is, the overall impact on total output of a dollar of stimulus. However, the CPA and IOL studies suggest a multiplier in the order of 2.2 and 1.7, respectively.

The Ontario Government study reports a decline in output and a net total loss in jobs of 62,000 by 1986. This is not particularly surprising since the Ontario study was not designed to examine the effect of stimulating the oil and gas industry but rather focussed on the effects of an oil price increase, where over half the incremental revenues are taken by government and not reinvested. In fact, the IOL study included an examination of a similar case and concluded, "The net effect of the price increase is to lower real economic activity while raising the general price level". Consequently, the results of the Ontario study do not really conflict with those of the other studies. The study simply dealt with another issue, namely the impact of higher oil prices with no other policy changes.

An important topic that was not dealt with in a comprehensive fashion in these studies is whether or not the oil and gas industry has any unique characteristics as a potential engine of growth. In other words, is there any reason to believe that a stimulus to the oil and gas industry would result in a contribution to overall economic performance that is different than a stimulus to any other sector of the economy? The following section summarizes the results of analysis undertaken by Gulf Canada to examine this question.

Energy and Growth Gulf Canada's Analysis

ASSUMPTIONS

- Each of the oil and gas and non-energy sectors are stimulated by a \$5 billion cash injection.
- In each case the total amount of the \$5 billion injection is invested
- The import content of investment spending is 37% for oil and gas and 25% for non-energy.

- The reinvestment ratio is assumed to be 1.0 in the oil and gas industry – at its recent historical performance.
- Assumptions regarding supply-side responses tend to improve the results for the non-energy sector.

Study Results

	GNP	TRADE BALANCE	GOVERNMENT BALANCE
OIL AND GAS	<ul style="list-style-type: none"> • Initial impact is strengthened considerably by increased oil and gas production; GNP averages ½ of 1% higher than base case in Limited Price Response Case. 	<ul style="list-style-type: none"> • Trade balance deteriorates initially due to capital goods imports but is ultimately improved through increased oil production. 	<ul style="list-style-type: none"> • The initial cash stimulus provided by government is repaid within five years. Large revenue contributions to government are made in the 1990's.
NON-ENERGY	<ul style="list-style-type: none"> • Near-term GNP impact is similar to similar to energy but impact diminishes over time; relies on improved domestic price performance for supporting trade effect; GNP 1/3 of 1% higher on average in optimistic case. 	<ul style="list-style-type: none"> • Trade balance deteriorates initially due to capital goods imports. Subsequent increase in production is adequate to reverse this, only in the optimistic case. 	<ul style="list-style-type: none"> • The initial cash stimulus is never totally repaid in either case.

Advantages of Oil and Gas Expansion

The federal government can and does use its fiscal influence to provide incentives for activity expansion in various sectors of the economy. These incentives will be more or less effective depending upon the dynamics of the response to the fiscal stimulus. Examination of policy alternatives requires a sufficiently broad analytical framework to capture the principal behavioural interactions in the economy. Consequently, the FOCUS model of the Institute for Policy Analysis of the University of Toronto was used to simulate policy options. (This is the same model used by the Ontario Government in its study.) Specifically, the effects were analyzed of providing a stimulus that increased investment by \$5 billion over five years in the oil and gas industry in the first case, and the non-energy goods-producing sector (hereafter called non-energy) in the second. Since the sole purpose of the following analysis is to trace the economic effects of increased investment throughout the Canadian economy, the specific amount of the stimulus as well as the manner in which this stimulus is delivered are chosen arbitrarily. The potential for increased investment in the oil and gas industry is evidently much greater.

The factors that most significantly affected the results are the following:

- (i) Cash reinvestment – over the past five years the cash reinvestment ratio for the upstream oil and gas industry has been slightly less than 100% (despite the negative impact of the NEP on investment intentions) compared to only 75% for the non-energy industry. Nevertheless, we assumed that all of the \$5 billion stimulus was invested in each case. Subsequent reinvestment was model-determined in the case of the non-energy industry. A reinvestment ratio of 1.0 was used for the oil and gas industry, in line with recent experience. This compares with an average ratio of approximately 1.1 used in the CPA study and 1.25 used in the IOL study.
- (ii) Import Leakages – the impact on the economy of the additional investment is weakened to the extent that it results in imports of capital goods. In the IOL study, the superiority of investment in the oil and gas industry is based on lower (compared to non-energy) import losses as measured in Statistics Canada's 1979 input-output model. However, this superiority could be exaggerated, depending upon the specific energy

projects undertaken. To avoid over-emphasis of this effect in our analysis, the record of the domestic versus import content of Western Canada oil and gas investment was combined with projections for the domestic/import split for Eastern Canada offshore investments.

- (iii) Price versus Output Responses – the effect on total output is dependent upon the manner in which increased demand reflects itself in price and production increases. The supply-side of the FOCUS model allows for alternative assumptions in this regard. The impact on the results of various assumptions was examined.
- (iv) Balance of Payments Effects – changes in demand and production alter imports and exports, which in turn affect the exchange rate. It was assumed that the Bank of Canada would not allow the Canadian dollar to fluctuate in an uncontrolled fashion but would maintain a relationship to the U.S. dollar, as it has generally attempted to do in recent years. Additional support for the Canadian dollar would provide the Bank with added flexibility in setting monetary policy.
- (v) Market Opportunities – a very significant factor that is not easily quantifiable is the availability of a market for the increased output. The government may want to stimulate a particular non-energy industry but the market may not be there to support increased output. That is, there may not be adequate domestic market growth, and import displacement or export expansion are simply not feasible. Oil and gas output on the other hand – and particularly oil – will have little difficulty finding a market in the medium term. However, to avoid influencing the results, no special allowance was made for this factor, other than those already built into the model's structure.

A number of simulation experiments were undertaken to examine the dynamic response of the investment stimulus provided to the oil and gas and non-energy sectors of the economy. Overall, a comparison of results shows that there are significant medium and long-term benefits to increased activity in the oil and gas industry. While increased activity in non-energy generates positive short-term benefits, these benefits are soon overshadowed by those obtainable through increased activity in the oil and gas sector.

Before examining the results of the simulations in any detail, a brief explanation of some supply-side relationships is necessary. The FOCUS model

incorporates interconnections between aggregate demand and the capability of the economy to supply that demand. An increase in total demand could call forth increased production or it could simply result in higher prices because of limitations to productive capacity. In addition to increasing total demand, higher investment, by changing the total capital stock, changes the economy's productive capacity. It is possible that the impact of the change in capital stock on supply capability would be relatively greater than that of the change in total demand such that prices could actually weaken.

If a stimulus to demand causes domestic price levels to rise, the balance of trade tends to weaken and this offsets part of the positive effect of the initial stimulus. It was conservatively assumed that all oil and gas investments would tend to cause some rise in the general price level. This reflects the fact that investment in the oil and gas sector increases the demand for capital goods without contributing towards an increase in their supply. This assumption biased the oil and gas investment cases downwards with respect to their effect on GNP and employment. Two cases were examined: a Maximum Price Response Case (the investment stimulus causes a larger price response) and a Limited Price Response Case.

As mentioned earlier, the change in the capital stock resulting from investment in the non-energy sector could conceivably cause prices to weaken. This follows from adding to capital in this sector when capacity utilization is already low. Lower prices would improve the balance of trade and add to the initial stimulus. Again, to be conservative it was assumed that non-energy investment is accompanied by price weakening. Two cases were examined: Maximum Price Response Case (the initial investment stimulus causes a substantial price weakening) and a Limited Price Response Case.

Examination of these four scenarios allows for coverage of the full range of supply responses. In general, because price adjustments are always increases for the oil and gas sector and decreases for the non-energy sector, the assumptions work in the direction of improving the relative results for the non-energy sector.

Theoretically, while prices could respond in a significant way to changes in demand and supply as defined in the model framework, it is unlikely as a practical matter that these price responses would be so predominant, given the magnitude of the assumed stimulus. Therefore, the Limited Price Response Case would appear to be the most likely for each sector.

Figure 10 compares the effects on GNP relative to the base case. The non-energy cases show a positive impact in the short-term, which weakens over the medium and long term, with the Limited Price Response Case becoming negative by 1995. This is due to a continual deterioration in the balance of payments and higher interest rates (compared to the base case). Both oil and gas cases show positive results throughout, particularly where the domestic price impact of the initial investment is limited. In the longer term, the most conservative oil and gas case is superior to the most optimistic non-energy case. Finally, it is worthwhile to note that, while our simulation results extend only to 1995, the production benefits from the oil related investments extend beyond the year 2010.

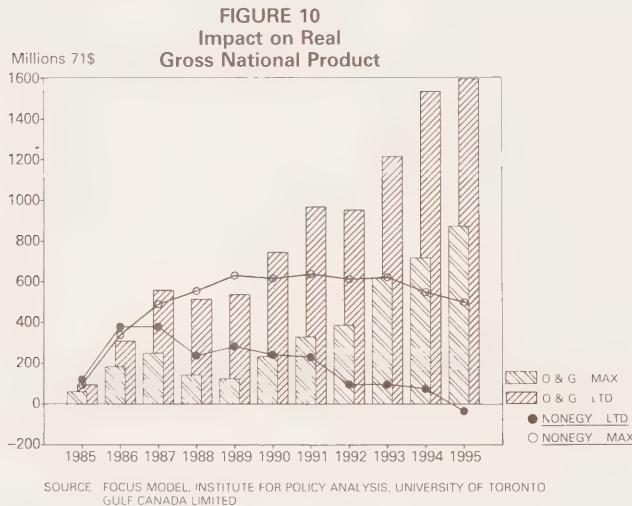
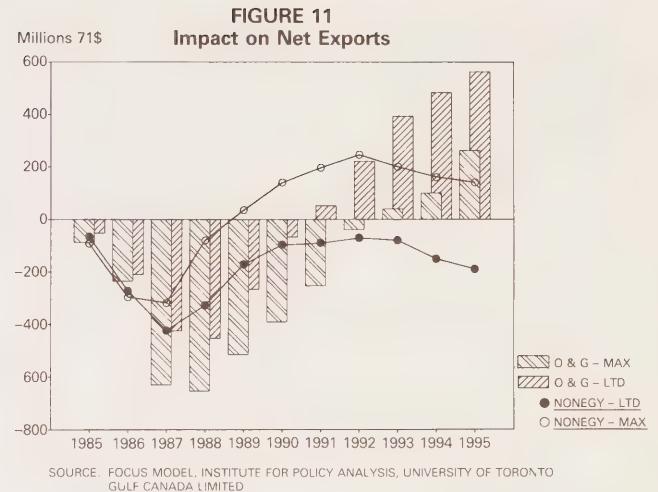


Figure 11 exhibits the change in Canada's net export position from the increases in investment. Initially, the trade balance deteriorates for both oil and gas and non-energy, due to the import content of the increased investment expenditures. For the non-energy investment stimulus it is assumed that, consistent with historical performance, approximately 25% of the sum of non-residential construction and machinery and equipment is imported. For oil and gas investment, 20% of Western Canada and 50% of East Coast investment is assumed to be imported – or 37% for overall import content. (This assumption is considerably more conservative than the CPA or IOL studies where energy investment was assumed to have the characteristics of non-residential construction spending, i.e. an import content of 10-15%.) Consequently, both the oil and gas and non-energy simulations show a similar short-run deterioration in net exports.



In the Maximum Price Response Case for oil and gas, a further deterioration in the trade account occurs as higher domestic prices lead to increased imports and lower exports. Given the low level of capacity utilization in Canada's economy at the present time, this simulation, with its price response, reflects a rather unrealistic result. In the Maximum Price Response Case for non-energy, declining domestic prices partially offset the deterioration in net exports resulting from imported capital goods. As the demand for non-energy production increases to match the expansion in production capacity, domestic prices begin to rise and slowly offset the earlier improvement in net exports.

After a three-year lag, the effects on oil and gas production of increased investment in this sector become increasingly evident. Each incremental barrel (of oil equivalent) either displaces imports or increases exports resulting in a significant improvement in Canada's balance of payments. In the longer run, it is again the case that the worst oil and gas case is superior to the best non-energy case in terms of its contribution to Canada's trade balance. As mentioned previously, an extension of our time horizon would indicate a continuation of the benefits from increased oil and gas investment and production.

It has been assumed, in all simulations, that the Bank of Canada tends to maintain the value of the Canadian dollar vis-a-vis the U.S. dollar. Improvements in the balance of payments, therefore, provide the Bank of Canada with room to lower interest rates. Figure 12 exhibits the implications of the simulations on long-term interest

rates. In the medium to long-term, the positive impact on Canada's balance of payments from increased oil production results in a considerable fall in interest rates, compared to the non-energy simulations. These simulations indicate that oil and gas investment, which leads to increased crude oil production, would give the Bank of Canada increased flexibility in setting domestic interest rates.

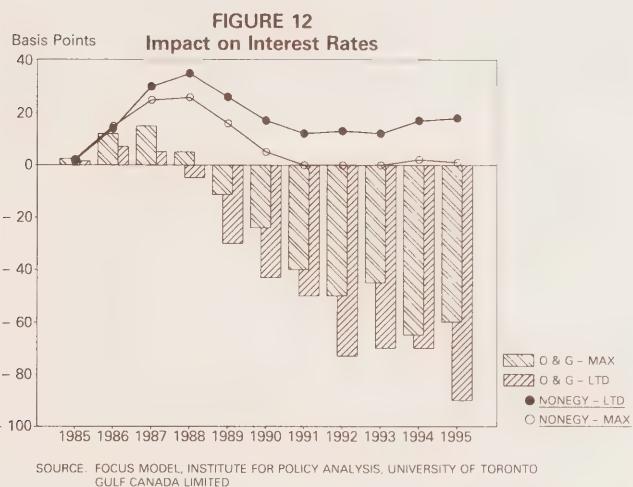


Figure 13 exhibits the initial and the subsequent induced amount of investment in total. In both the oil and gas simulations, significant amounts of additional investment are generated as a result of lower interest rates, increased cash flow and higher levels of domestic activity. Of the induced investment, approximately 40% is in the form of increased non-energy investment in the Maximum Price Response Case and 60% in the Limited Price Response Case. The remainder of the induced investment is energy related and is mainly a function of the assumed oil and gas re-investment rate. While the induced oil and gas investment is affected by the re-investment rate, it is not overly-sensitive to this factor. For example, an alternative simulation with a 50% re-investment rate results in a 20% decrease in the induced oil and gas investment and between 8-12% in overall induced investment.

With respect to the non-energy sector, the induced investment is dependent upon the extent of capacity utilization in the economy. Since this is low in the early years of the simulation, induced, non-energy investment is relatively low.

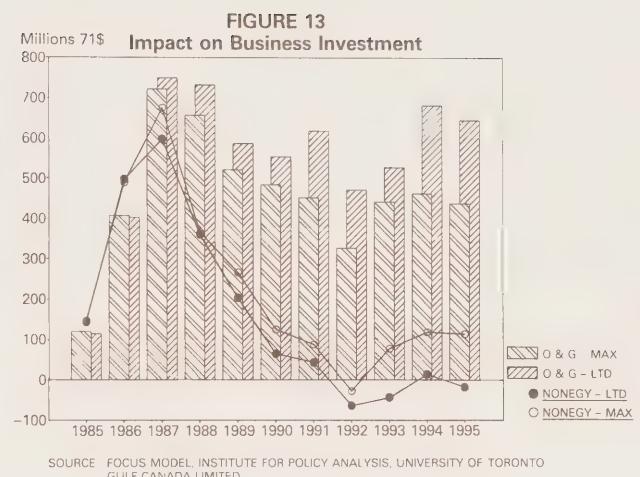


Figure 14 exhibits the impact on employment (relative to the base case) from the stimulus to investment in oil and gas and in non-energy. Initially there is very little difference between the increase in employment for oil and gas and non-energy. As the initial oil and gas investment triggers second round increases in both energy and non-energy investment, the resulting higher capital/labour ratio improves labour productivity. This in turn leads to slightly higher wages and lower employment but a more productive economy than in the non-energy cases. These results are not surprising given the capital intensiveness of the oil and gas sector compared to the non-energy sector. In the longer term, however, employment is increased by 40-50 thousand jobs per year in all cases.

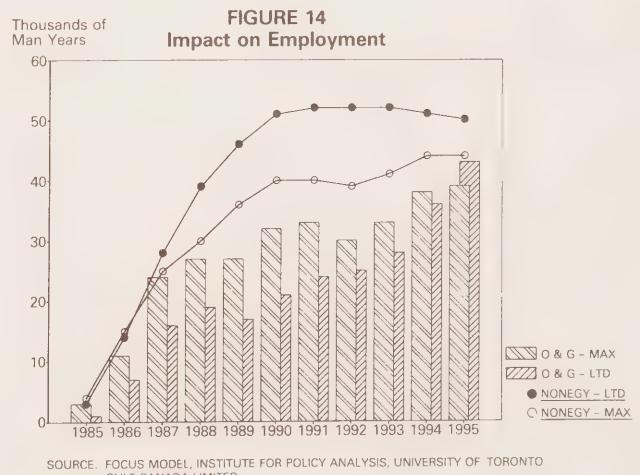
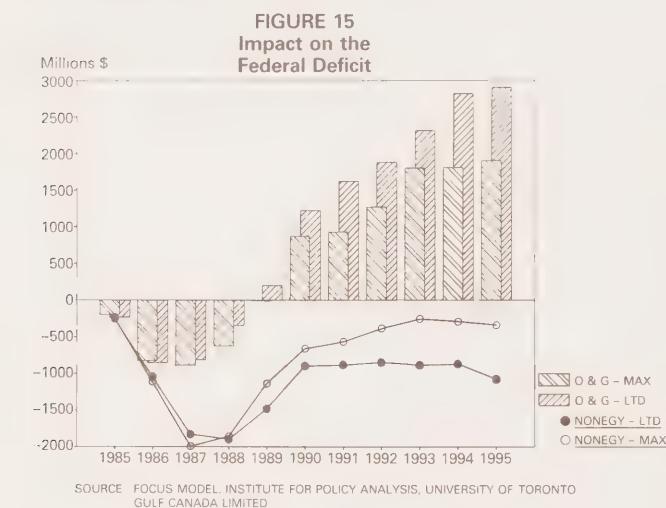


Figure 15 exhibits the net impact on Federal government balances of both the initial stimulus to investment (a \$5 billion loss) and the increase in revenues from expanded activity. Clearly, the oil and gas simulations indicate that the Federal government will recoup its investment incentive faster than in the non-energy case. The petroleum industries' higher (than non-energy) effective tax rate and the impact on economic activity from the oil and gas stimulus reduce the level of the deficit by \$2-3 billion per year by the end of the simulation period. Non-energy, on the other hand, never recaptures the funds initially injected.



In summary, our analysis demonstrates that the oil and gas industry is an "engine of growth" that is ready to contribute to maximizing Canada's economic growth potential. This is true even after making conservative assumptions with regard to the import content of oil and gas investment, the reinvestment ratio in the oil and gas industry, and the relative impacts of the two sectors on domestic prices and hence on the balance of trade in the near term.

Other industries in Canada's economy may not be in a similar position. Segments in manufacturing and in non-energy resources, for example, face eroding market share due to competition from imports as well as a reduced ability to compete in foreign markets. Moreover, levels of effective use of productive capacity remain lower than 80%, as in the case of chemicals, machinery and equipment, electrical non-metallic and miscellaneous producers. Consequently, cash injections by government may not necessarily result in increased spending, as has been assumed in this study.

For these reasons, it is unlikely that many industries outside the oil and gas sector, at this point in time, would respond to incentives in the same way. Moreover, there are few areas where investment and production can be stimulated on a scale that will have a significant effect on the overall level of economic activity. In the foregoing comparative analysis, an increment in investment of just \$5 billion was assumed. But as other studies have shown this increment could be in the order of \$50-100 billion, measured in 1985 dollars. These studies have also shown that increased investment of this magnitude could increase GNP in 1995 by 2-5% and employment by 200-300 thousand per year on average. This potential is unmatched in the Canadian economy.

Recommended Action

Various studies, including that prepared by Gulf Canada Ltd., have shown that the oil and gas industry can contribute in a significant and unique way to renewed vitality in the Canadian economy. This will require major changes in energy policy. In the broadest terms it will require a different approach to policy from the interventionist and often punitive measures introduced through the National Energy Program. New policy initiatives should be based upon the operation of markets, be sufficiently flexible to accommodate changes in international conditions, provide for an equitable sharing of the risks and returns from exploration and development, minimize uncertainties generated by federal-provincial conflicts over jurisdictions and revenue-sharing, eliminate the discriminatory treatment of industry participants on the basis of ownership and remove the onerous retroactive features of previous policy measures.

Guided by these general principles, the following specific policy measures are recommended:

Oil and Gas Pricing: Pricing policy must recognize that Canada is a price taker in international markets and allow domestic oil and gas prices to be determined by the interplay between domestic and international market forces. In the case of oil this means eliminating the administered dual pricing system which has distorted behaviour with respect to both consumption and production decisions. In addition, volume decontrol (elimination of constraints on exports/imports for oil products and crude oil) will be required to ensure efficient and internationally competitive Canadian oil prices. Such a market-based system would ensure that Canadian oil prices are set in relation to world market conditions. In

the case of gas, because of longer-term contractual commitments and current institutional impediments, decontrol would have to be phased in over a period of two-to-three years. This would require significant changes in the current market structure, including a separation of monopolistic transportation functions from competitive marketing and production functions. Similarly, gas export prices must be based on competitive conditions in export markets.

Revenue-Sharing: Current revenue-sharing arrangements do not adequately recognize the risk and capital intensity of energy investments. Re-establishment of a fairer balancing of risks and rewards will require major changes in fiscal measures:

- The current dual royalty scheme for conventional oil is onerous and should be replaced by a single royalty with rates comparable to those now in place for NORP oil.
- The Petroleum and Gas Revenue Tax (PGRT) should be phased out and replaced by a profit-based tax. This could be done by immediately eliminating the PGRT on production from all new wells and reducing the effective PGRT rate from 12% to 8%. The PGRT would then be phased out over the next three years. This would minimize the sudden loss of federal government revenues.
- Petroleum Incentive Payment (PIP) grants should be eliminated in favour of tax-based incentives related to investment activity such as depletion. These incentives would have to be transferable to ensure that all companies could utilize them.
- The Progressive Incremental Royalty should be relied upon more extensively for the provision of oil and gas revenues to government in the Canada Lands. This would allow industry to reduce its risk by shortening the long payout period associated with these projects, while ensuring that government collects a large share of revenues from those projects that are characterized by high economic rents.

These changes would collectively increase the profit orientation of oil and gas taxation.

Canadianization: Canadianization objectives should be realized through positive inducements to Canadians to purchase equities in oil and gas companies rather than through discriminating fiscal treatment of these companies. At the same time foreign-controlled companies should be encouraged to facilitate greater

participation by Canadians in company ownership.

Security of Supply: While Canada is currently a net exporter of oil, its conventional resource base is projected to diminish rapidly over the next ten years. Moreover, Eastern Canada remains largely dependent upon imported oil. Given that Canada does have substantial resource potential in the frontier and non-conventional areas, these factors provide convincing arguments for the continual provision of incentives for exploration and development.

Retroactive Government Participation: Retroactive participation by governments in oil and gas ventures by way of the “back-in” provision of the NEP is unacceptable to industry and seriously undermines trust in government’s intent to carry out its commitments. The back-in provision should be eliminated.

Energy Conservation: Conservation should be encouraged through the influence of the price of energy as determined in the marketplace. Expensive conservation support programs should be phased out with government participation emphasizing the provision of information and the undertaking of demonstration projects.

Federal-Provincial Policy Co-ordination: To avoid the disruptive effects of federal-provincial conflicts over jurisdiction and revenue-sharing, we encourage both levels of government to put in place the means to establish agreed principles on policy co-ordination. As a minimum, this would imply regular meetings of officials to anticipate and resolve problem areas, rather than the historical approach of conflict followed by crisis resolution.

The above policy initiatives would contribute towards a better climate for oil and gas investments, a healthier oil and gas industry to undertake these investments, improved efficiency in energy resource allocation, fairer treatment of participants in oil and gas development and greater participation of Canadians in the oil and gas business without resorting to punitive measures. In this environment a reinvigorated oil and gas industry would be able to contribute its full potential to expanding the Canadian economy.

CONSENSUS BUILDING

Overcoming the obstacles to economic growth and building on the real opportunities available to Canada will require a concerted effort by business, government and labour: realization of our potential will not happen simply

because we want it to, it will only occur if we act collectively and decisively to make the necessary adjustments. This will require close co-operation and consultation among what are all too often three solitudes.

Gulf Canada has been concerned for some time that no effective mechanism exists in Canada to facilitate the consultation required to meet today's challenges. Early in 1983, Gulf proposed the creation of an advisory group to consult with government. The concept was modest, involving a small group of front-line people from all three sectors and encompassing representation from the various regions. The composition of the group would be fluid and flexible, depending on the issues at hand, and the purpose would be to identify and recommend specific proposals for action on a few basic but essential issues which are amenable to short-term action. The reaction to this proposal was strong and supportive – from private citizens, prominent business people and government officials alike.

We interpreted that reaction as an indication that Canadians were eager to see a process of national reconciliation begin and to participate in it. Gulf's own small contribution to the process has been to launch a new publication, called the **Commentator**, which we hoped would provide a forum for rational discussion of the key social and political issues facing the country today. The public response to the first three issues of **Commentator** has been very gratifying. We feel that we have touched a responsive chord in Canadians and Gulf intends to continue to provide this platform for informed debate on matters of national interest.

Recommended Action

Looking at the consultation process more broadly, there are a number of avenues available for bringing public concerns to bear on the public policy decision-making process; no one route works best for all issues and groups and several routes may be pursued coincidentally. First, there are formal mechanisms such as the Canadian Labour Market and Productivity Centre which bring labour and business together to advise government on broad issues, in this case productivity improvement, labour market requirements and employment growth. The Centre is funded by government and is intended to provide ongoing advice not directly linked to immediate issues or legislation but which is able to take a longer-term, comprehensive approach to major structural problems.

Second, this approach should be complemented by less formal, more flexible vehicles, such as that proposed by Gulf, which are designed to respond to immediate, short-term problems with specific recommendations for action.

Third, in view of the difficult political trade-offs which will be required to effectively address critical policy issues, such as the need to bring the structural deficit under control, it is essential that the resource allocation process be open and responsive to interventions by organized interests. The process should provide clear, easily identifiable avenues of access for individual groups concerned about specific issues. For the system to operate effectively, individual Ministers, supported by strong personal staffs, must be identifiable as the key players responsible for making decisions within their own policy areas. There is no adequate substitute for ongoing, direct consultation at the political level with relevant interest groups. This process allows politicians to make informed resource allocation choices after weighing the merits of competing interests.

Finally, in order to promote more public discussion and interest in public policy decisions, a more extensive use of parliamentary committees, (which is already under consideration by the government), should be actively pursued. They would serve as a forum in which a thorough discussion of issues can occur. It is important to acknowledge that under the parliamentary system this use of committees cannot be considered as an opportunity to affect the voting intentions of individual members, but rather as a way to ensure that important issues receive a public airing.

There are clearly a number of different ways for effective consultation to occur. The most important ingredient is an evident desire by government to listen and to respond. Since Gulf became interested and involved in this issue of improved relations between the various sectors in society, a new government has been elected which has pledged to making consensus-building and consultation its modus operandi. We have begun to see clear evidence of this approach at work and like most Canadians we are encouraged.

Conclusions

Over the past fifteen years the attitude of Canadians has shifted subtly from an unconstrained optimism about the country's future to frustration over our apparent inability to come to grips with the chronic problems of poor productivity, lower than potential economic growth, mounting government deficits, business/labour and intergovernmental rivalries and stubbornly high unemployment rates. The socio-economic climate that will confront the country in the years ahead will not make it any easier to resolve these issues. On the contrary an increasingly competitive international trade environment, structural adjustments resulting from technological innovations and continuing demands for improvements in social services make it all the more essential that initiatives be taken now to establish the needed policy context for renewed economic vitality in Canada.

Economic policy must begin with a recognition of the paramount role of individual initiative working through the marketplace. The evolution of regulatory restrictions and direct interventions by governments have seriously undermined the allocative efficiency of market mechanisms. It is time to shift the onus back to those who would regulate to justify the need for intervention.

Policy must also recognize the exposure of the Canadian economy to international market forces. In the Canadian context a comprehensive industrial policy or strategy should mean consistency among the various components of economic policy and predictability, not picking winners and losers. This implies that we cannot afford to have development and energy policies, for example, working at cross purposes.

Within the framework of these general policy guidelines Canada must establish short-term policy priorities. These would include the following:

Fiscal Control: Eliminate the structural deficit (estimated to be between \$15-20 billion) over five years by constraining growth in government spending to be less than GNP expansion and by consumption-oriented taxes that would increase revenue growth. Simultaneously initiate a review of federal taxation with the objective of achieving fairness, efficiency and simplicity.

Reduce the Burden of Regulation: Limit regulation and intervention to the minimum necessary to ensure competitive markets and to achieve legitimate equity goals. Where regulation is necessary employ techniques that minimize the costs to consumers. Use parliamentary

committees to provide an ongoing audit of the need for existing regulation.

Trade Expansion: The full range of trade options is best assured by continuing to work for trade liberalization through the GATT. At the same time efforts should be made to negotiate a more comprehensive trade agreement with our most important trading partner, the United States, within parameters of bilateral agreements sanctioned by GATT.

Energy & Growth: Capitalize on the potential contribution to economic growth of a rejuvenated oil and gas industry. This will require moving to market-based pricing, an end to discriminatory fiscal policies and revenue-sharing arrangements that share risk and revenues in a more equitable manner.

Consensus Building: Expand the opportunities for input from interested parties to government on policy matters. The mechanisms should include formalized institutional arrangements, such as the Canadian Labour Market and Productivity Centre, informal tripartite advisory groups focussing on short-term issues, such as the type recommended by Gulf Canada in the past, and easily-identified avenues of access to Ministers' offices through support staff for ongoing consultation on an ad hoc basis.

Concentration of policy efforts in these areas in the near term would begin the process of eliminating impediments to improved economic performance and would give a clear signal that individual effort will be encouraged and rewarded. The policy direction having clearly been established, Canada can then fully utilize its considerable natural and human resources in realizing its full potential.

